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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 1021.

LEGH R. POWELL, JR., AND HENRY W. ANDERSON, AS RECEIVERS OF THE PROPERTIES OF SEABOARD AIR LINE RAILWAY COMPANY,

Petitioners,

against

MARYLAND TRUST COMPANY, AS SUCCESSOR TRUSTEE UNDER THE FIRST MORTGAGE OF SEABOARD AIR LINE RAILWAY DATED APRIL 14, 1900.

Respondent.

BRIEF ON BEHALF OF MARYLAND TRUST COMPANY, AS SUCCESSOR TRUSTEE UNDER THE FIRST MORTGAGE OF SEABOARD AIRLINE RAILWAY, IN OPPOSITION TO THE PETITION AND BRIEF OF LEGH R. POWELL, JR., AND HENRY W. ANDERSON, AS RECEIVERS OF SEABOARD AIR LINE RAILWAY COMPANY, FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

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OPINIONS OF THE COURTS BELOW.

The Report of Special Master James E. Heath, to whom this case was referred by the District Court for the Eastern

District of Virginia, is printed at page 132 of the Record. The opinion of the District Court, confirming and modifying the Report of the Special Master, is printed at page 185 of the Record and has not yet been officially reported. The opinion of the Circuit Court of Appeals appears at page 199 of the Record and is officially reported in 125 Fed. (2d) page 260.

JURISDICTION.

Jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (Chapter 229, 43 Stat. 936).

STATEMENT OF THE CASE.

The facts are not in dispute and have been agreed upon in a Stipulation of Facts. In the opinion of counsel for the First Mortgage Trustee, the detailed statement appearing in the Receivers' brief tends to confuse the limited issues raised by their petition. In the interest of clarity and conciseness, therefore, it is deemed desirable to make a short statement of only those facts which are essential to the questions to be decided.

At the outset, it should be said that this controversy involves the disposition of 2,225 shares of the capital stock of the Richmond-Washington Company, a corporation of the State of New Jersey (hereinafter referred to as R-W Company) and certain cash dividends amounting (when these proceedings were commenced) to $142,956.25. The 2,225 shares of stock were paid on October 31, 1930 as a 50% stock dividend upon 4,450 shares of the stock of that company held in pledge by the Maryland Trust Company, Successor Trustee under the First Mortgage from Seaboard Air Line Railway (hereinafter referred to as Seaboard) dated April 14, 1900. The cash dividends were

paid by the R-W Company upon both the 4,450 shares of stock held by the First Mortgage Trustee and upon the 2,225 shares. All the cash dividends in question were paid at various dates after the appointment on December 23, 1930 of Receivers for Seaboard.

The contention of the Maryland Trust Company is that under the terms of the First Mortgage, under which it is acting as Successor Trustee, it is entitled to the 2,225 stock dividend shares and to all of the cash dividends referred to. Its position is that the stock dividend did not come within the reservation of dividends in favor of Seaboard under the terms of Section 1 of Article Three of the First Mortgage (R. 47) and that these shares, upon their declaration and payment, became a part of the original pledge of the 4,450 shares of R-W Company stock theretofore held in pledge. As to the cash dividends, the position of the Maryland Trust Company is that under the terms of the First Mortgage, the appointment of the Receivers constituted an event of default which terminated the right of Seaboard to receive any further dividends of any character whatsoever paid upon the pledged securities.

A third claimant to the stock dividend and to the cash dividends paid upon said stock dividend is The New York Trust Company, Trustee under the Refunding Mortgage from Seaboard Air Line Railway dated October 1, 1909. By the terms of that Mortgage, Seaboard agreed to pledge with the original trustees thereunder, at that time Mortimer N. Buckner (whose death occurred after these proceedings were commenced) and The New York Trust Company, all shares of R-W Company stock thereafter acquired by Seaboard. The claim of The New York Trust Company becomes an issue only in the event that the stock dividend is not awarded to the First Mortgage Trustee.

The late James E. Heath, the Special Master appointed by the District Court to pass upon these matters, concluded that the First Mortgage Trustee was entitled to the 2,225 stock dividend shares and to all of the cash dividends, including both the dividends paid upon the original 4,450 shares as well as to those paid upon the 2,225 stock dividend shares. The opinion of the Special Master was affirmed by the District Court with one exception not material to state here. The decree of the District Court was sustained by the Circuit Court of Appeals except as it modified the conclusions reached by the Special Master. The case now stands, therefore, as the Special Master originally decided it.

The First Mortgage was executed in the year 1900 to secure a large issue of bonds, of which $12,768,000 principal amount are now outstanding in the hands of the public. As security for these bonds, Seaboard mortgaged its main line of railway and lodged with the Trustee various bonds and stocks. A provision in the Mortgage permitted Seaboard to pledge further securities with the Trustee and, acting under this authority, Seaboard pledged with the First Mortgage Trustee, in December, 1901, certificates representing the 4,450 shares of the capital stock of the R-W Company. These shares were, and have at all times continued to be, subject to the lien of the First Mortgage.

Section 1 of Article Three of the Mortgage (R. 47) provides that unless Seaboard shall be in default, it shall be entitled to receive "all interest paid or dividends declared in respect of any bonds or stocks transferred to or pledged with the Trustee". The question raised by the Receivers is whether this reservation of dividends in favor of Seaboard is broad enough to include stock dividends as well as cash dividends. The answer depends upon the

proper construction of the First Mortgage and it is admitted by all parties that State law is controlling. The Receivers insist that the applicable State law is the law of the State of Maryland and that under the Maryland decisions, properly construed, Seaboard became entitled to the stock dividend paid by the R-W Company. While admitting that State laws control, the First Mortgage Trustee has at all times contended that the construction of the reservation of dividends, as used in the First Mortgage, is governed by the law of Virginia and North Carolina, the domicile of Seaboard at the time of the creation of the First Mortgage. For the purpose of this brief, however, the case will be argued as though all questions in connection with the pledge and the construction of the First Mortgage are controlled by the law of Maryland.

The Receivers have raised an additional question which involves a consideration of the Receivers' Certificates issued pursuant to Receivers' Applications Nos. 19, 63 and 160 (R. 87). The cash dividends and the certificates representing the stock dividend were in the possession of the Receivers at the time the Receivers' Certificates were issued. The Receivers argue, therefore, that these dividends as well as the railway properties of Seaboard became subject to the lien of the Receivers' Certificates.

ARGUMENT.

The argument of the First Mortgage Trustee will be divided into two classifications, the first designed to show that there are no special circumstances within the meaning of Rule 38 of this Court justifying a review of this case, and the second, that irrespective of any other consideration, a review should be denied because the opinion of the majority of the Circuit Court of Appeals was in conformity with applicable State law.

I.

NO SPECIAL OR IMPORTANT REASONS EXIST WHICH JUSTIFY A REVIEW OF THIS CASE.

Paragraph 5 of Rule 38 of the rules of this Court furnishes a guide as to matters which are reviewable upon a petition for a writ of certiorari. It is there stated that a review is not a matter of right but of sound judicial discretion and "will be granted only where there are special and important reasons therefor". It is submitted that no such special or important reasons justify a review in this case. On the contrary, it is in the public interest that the pending plans for the reorganization of Seaboard (already over eleven years in receivership) be completed as promptly as possible. Further litigation of the important issues involved herein can only delay and retard that objective.

The questions involved here have been passed upon at three different stages, first by a Special Master appointed by the District Court for the Eastern District of Virginia, subsequently by the District Court itself and, finally, by the Circuit Court of Appeals for the Fourth Circuit. Except for the dissenting opinion of Judge Soper, which is limited solely to one issue, the opinions have been unanimous in holding that the First Mortgage Trustee is entitled to the stock dividend shares. It would not seem that the Receivers, being neutral parties and mere officers of the District Court, are justified in litigating these matters further. This is particularly true of the question pertaining to the effect and scope of the lien of the Receivers' Certificates. The holders of these Certificates have been represented by a committee from the time of the Receivership and it is pertinent to observe that at no stage of the proceedings has the committee thought it necessary to intervene or to take any active part in this controversy.

Chief Judge Parker commented upon this. He said (R. 217):

> "So far as the claim of lien by reason of the issuance of receivers' certificates is concerned, it is a sufficient answer that no holder of any of these certificates is before us claiming any such lien."

The Receivers' petition is justified, if at all, only by the provisions of paragraph 5(b) of Rule 38 of this Court which permits a review where a Circuit Court of Appeals "has decided an important question of local law in a way probably in conflict with applicable local decisions". The disposition of the stock dividend depends in the final analysis upon the meaning to be attached to the reservation of dividends by Seaboard under the First Mortgage. If, under that reservation, stock as well as cash dividends were covered, then unquestionably the Receivers of Seaboard are entitled to the 2,225 stock dividend shares, but if, on the contrary, the parties intended only cash dividends, then it clearly follows that the stock dividend shares should be awarded to the First Mortgage Trustee.

It is submitted that there are no grounds to support the dissenting Judge's conclusion that the reservation of dividends under Article Three, Section 1, coupled with other provisions of the Mortgage, demonstrated an intent on the part of Seaboard to reserve all income upon the pledged securities. Article Nine of the Mortgage upon which the dissenting Judge relied (R. 64) is confined solely to the rights of Seaboard over the railroad properties subject to the Mortgage. As to these, Seaboard clearly reserved the right to all profits, earnings and income. But Seaboard's rights *as pledgor* are governed exclusively by Article Three, entitled, "As to Stocks and Bonds Here-

under". Whatever Seaboard's unexpressed intent may have been, its written contract is controlling. As will be shown, in the absence of some agreement to the contrary, the common law awards all dividends, both cash and stock, to the pledgee. The field of inquiry, therefore, of necessity turns upon the meaning of the word "dividends" as used in the reservation under Section 1 of Article Three.

The majority of the Circuit Court of Appeals recognized this to be the turning point of the case and they recognized, all of them, that under the decision of Erie Railroad v. Tompkins, 304 U. S. 64, State law is controlling. It was said in the majority opinion (R. 203):

> "The mortgage was delivered to the first mortgage trustee and accepted by it in Baltimore, Maryland, and the shares of stock which were pledged were delivered to it there; and there is no serious question but that the law of Maryland is the law properly applicable in determining the rights of the parties with respect to the stock dividend."

The same conclusion was reached by the Special Master and the District Court.

Now the stumbling block in this controversy is the fact that there is no Maryland case, nor any decision in any other jurisdiction, precisely in point. A review of the various opinions in this case shows this to be so. The Special Master said (R. 145):

> "There is no Maryland case precisely in point * * * that is to say, no Maryland case construing the same or a similar reservation in a pledge of stock. But, upon principle, I think the claim of the First Mortgage Trustee is sound and *I am also of the opinion that the Maryland Court has clearly indicated that it is in accord with this view.*" (Italics ours.)

And in the opinion of the majority of the Circuit Court of Appeals, it was said (R. 204):

> "The precise question is not covered by any Maryland decision; but it is worthy of note that in the case of Smith v. Hooper, 95 Md. 16, 51 Atl. 844, Chief Judge McSherry quotes with approval from Stoner v. Phillips, 62 Conn. 62, 24 Atl. 524, 16 L. R. A. 461, 'that the word "dividend", if unqualified, signifies dividends payable in money.' "

Judge Soper, dissenting, made a similar admission, (R. 221):

> "We are obliged in the pending case to search for and apply the Maryland law in the interpretation of a trust indenture from a railroad company to a trustee to secure an issue of mortgage bonds, *and to construe a clause of the contract that is without precise precedent in judicial decision in Maryland or elsewhere, so far as search of the authorities has disclosed.*" (Italics ours.)

And the Receivers in their brief say:

> "There appears to be no cases, in Maryland or elsewhere, directly involving the particular question of the nature of a stock dividend and the rights as between pledgor and pledgee where dividends are reserved to the former, * * *"

It cannot be said that the majority of the Circuit Court of Appeals failed to recognize or to give full effect to the doctrine of the Erie Railroad case and to all of its implications as set forth in such cases as Ruhlin v. New York Life Insurance Co., 304 U. S. 202 and West v. American Tel. & Tel. Co., 311 U. S. 223, which hold that a Federal court, exercising jurisdiction on grounds of diversity of citizenship, must search for and apply the entire body of substantive law governing an identical action in the State courts. The majority recognized that such law is to be ap-

plied rather than to prescribe a different rule, however superior it may seem from the viewpoint of general law and however much the State law may have departed from prior decisions of the Federal court.

In its effort to follow the Erie Railroad rule, the majority carefully sifted and analyzed the various Maryland decisions. Reliance was placed upon the case of Gemmell v. Davis, 75 Md. 546, 23 Atl. 1032, which holds that the pledgee is entitled to all dividends upon pledged securities. Reliance was also placed upon the important case of Smith v. Hooper, 95 Md. 16, 51 Atl. 844, in which it was held by Chief Judge McSherry that the word "dividend", if unqualified, signifies dividends payable in money. The court rejected, properly so for the reasons enumerated on page 21 of this brief, the Maryland trust apportionment rule. That rule, now abrogated by statute, can have no application to a pledge where the issue turns upon the precise legal meaning of the reservation of "dividends" as used in the contract of pledge. Notwithstanding any statements in the dissenting opinion of Judge Soper to the contrary, the only charge that the dissenting Judge can lodge against the majority is that they failed to agree with his conclusions first, that Seaboard reserved all income, rather than merely dividends, upon pledged securities and second, that the Maryland trust rule of apportionment is applicable by way of analogy. There is nothing to warrant his statement that the majority in any way failed to give full scope and effect to the Erie Railroad decision. In support of the majority it should be said that the dissenting Judge could point to no Maryland case holding the analogy to be sound.

A careful analysis of both the majority and dissenting opinions reveals that the different results reached stems from the inability of members of the court to agree upon

the construction to be given to the First Mortgage. Judge Soper concluded that Seaboard intended to and in fact did reserve all income upon the pledged securities. In order to support his position, it is necessary to read into the Mortgage not only a reservation of income in favor of Seaboard but a reservation only of income which accrued after the date of the creation of the Mortgage, but not prior to that time. In accordance with the Maryland Trust apportionment rule which he accepted and applied, the dissenting Judge would have awarded the Trustee so much of the stock dividend as was paid from earnings, had there been such, accumulated prior to the date of the pledge. This, however, requires reading something into the contract of pledge which does not exist. Chief Judge Parker, speaking for the majority, correctly said, "No such question is presented here. There is no reservation of income to the Seaboard." The inability of the court to agree upon the construction of the Mortgage does not present a question of local law. No search of authorities would be of particular assistance in the solution of this question. It must be resolved in each instance by the court before whom the question arises.

The Receivers as well as the dissenting Judge object to the reliance placed by the majority upon such cases as Kaufman v. Charlottesville Woolen Mills, 93 Va. 673, 25 S. E. 1003, and Lancaster Trust Co. v. Mason, 152 N. C. 660, 68 S. E. 235, and to the line of Federal decisions commencing with Gibbons v. Mahon, 136 U. S. 549. It is submitted that it was entirely proper for the court to look for guidance to these decisions. Particularly is this true of the Kaufman and Lancaster Trust Co. cases, because the questions there at issue were the effect to be given to a reservation of dividends under contracts of sale. The Spe-

cial Master grasped their full significance when he said in his Report (R. 148):

> "It should be emphasized just how apposite these two decisions are. They dealt, not with testamentary trusts, but with the rights of the parties to a contract, and their reasoning was based upon the essential difference between a stock dividend and a cash dividend, that is to say, upon the fact that the former was not really a dividend."

In rejecting the applicability of the Maryland trust apportionment rule to a pledge situation, the majority simply refused to follow a line of cases which, in their judgment and on the facts of this case, they felt the Maryland Court of Appeals itself would never have followed or applied. Upon this point, Judge Parker quite properly said (Record, p. 212):

> "To apply the rule which they lay down with respect to the rights of life tenant and remainderman to the question before us, instead of the rule prescribed by reason for such a situation, is not required by Erie Railroad Co. v. Thompkins, 304 U. S. 64, or by any other decision. To reason from analogy and apply the rule because of what we may guess the Maryland court would have decided if the case had been before it, is to indulge in vain speculation."

It is to be observed in this connection that in 1939, the Maryland Legislature discarded the trust apportionment rule in favor of the Federal or Massachusetts rule. See Flack's Annotated Code of Maryland, Volume II, Article 75B. The apportionment rule, with its host of practical difficulties in operation having been abolished by legislative fiat, it cannot be supposed that a Maryland Court would today lend a hand in its rebirth. To inject this rule again into Maryland law, as the dissenting Judge would have us to, can only lead to conflict and further confusion.

This Court cautioned against this danger in Vandenbark vs. Owens-Illinois Glass Company, 311 U. S. 538. The question at issue in that case was whether the holding of a Federal District Court should have been reversed by the Circuit Court of Appeals because of a change in State law after the opinion of the District Court. The Circuit Court of Appeals refused to disturb the opinion of the District Court and its decision was reversed by this Court. Speaking through Justice Reed, this Court said:

> "While not insensible to possible complications, we are of the view that, until such time as the case is no longer *sub judice*, the duty rests upon federal courts to apply state law under the Rules of Decision in accordance with the then controlling decision of the highest state court. Any other conclusion would but perpetuate the confusion and injustices arising from inconsistent federal and state interpretations of state law."

It cannot be said that the present case bears any resemblance to such decisions as Fidelity Union Trust Co. v. Field, 311 U. S. 169, Six Companies of California v. Joint Highway District, 311 U. S. 180, West v. American Tel. & Tel. Co., supra, and Stoner v. New York Life Insurance Co., 311 U. S. 464. In all of these, the respective Circuits Courts of Appeal intentionally and knowingly refused to follow applicable lower court decisions. Each was reversed in this Court upon the ground that the Erie Railroad case requires a Federal court to follow the applicable decisions of a lower State court in the absence of a decision by the highest appellate court.

Whether the majority of the Circuit Court of Appeals was correct in rejecting the application of the Maryland trust apportionment rule is a question that must forever remain unanswered until decided by a Maryland court. This Court has heretofore shown its reluctance

to indulge in vain speculation as to what the State law might be in the absence of some decision in point. See Helvering v. Fuller, 310 U. S. 69, and Railroad Commission of Texas v. Pullman Co., 312 U. S. 496, 501, and also Ruhlin v. New York Life Insurance Co., supra, at p. 206. And in the recent case of Macgregor v. State Mutual Life Assurance Co., decided February 16, 1942 and reported in the United States Law Week, Vol. 10, Sec. 4, p. 4214, this Court refused to disturb the opinion of the Circuit Court of Appeals for the Sixth Circuit in the absence of a State decision in point. It was there said:

> "No decision of the Supreme Court of Michigan, or of any other court of that State, construing the relevant Michigan law has been brought to our attention. *In the absence of such guidance, we shall leave undisturbed the interpretation placed upon purely local law by a Michigan Federal judge of long experience and by three Circuit judges whose Circuit includes Michigan.*" (Italics ours.)

Somewhat the same line of reasoning was adopted in Railroad Commission v. Pullman, supra, where this Court refused to pass upon a question involving the interpretation of a Texas statute. The Court remanded the cause to the District Court with direction to retain the bill pending a determination of the precise question by a Texas court. It was said at page 499 of the United States report:

> "The lower court did deny that the Texas statutes sustained the Commission's assertion of power and this represents the view of an able and experienced judge of the Circuit which includes Texas and of two capable District judges trained in Texas law. Had we or they no choice in the matter but to decide what is the law of the state, we should hesitate long before rejecting their forecast of Texas law. But no matter

how seasoned the judgment of the District Court may be, it cannot escape being a forecast rather than a determination."

Situations are certain to arise where Federal courts are called upon to decide problems of first impression, and the Courts must of necessity be free to look to all applicable decisions, irrespective of the jurisdiction, and to apply their own reasoning in the solution of the problem to be solved. In the recent case of Lich v. U. S. Rubber Co., for example, reported in 39 Fed. Supp. 675, the District Court for the District of New Jersey felt free to rely upon the definition of a stock dividend as decided by this Court in Eisner v. Macomber, supra. See page 683 of the Report. It is submitted that the correct rule is well summarized in the recent case of Simmons v. Simmons, decided November 6, 1941 by the District Court for the Eastern District of South Carolina and reported in 41 Fed. Supp. 545. The case was one involving a new point of law and in its approach the Court applied much the same line of reasoning as the majority of the Circuit Court of Appeals in the present case. The Court said at page 547:

> "As to this phase, this is a case of novel impression, and it is regrettable that it arises in a Federal court rather than in a court of the State of South Carolina. It is conceded by counsel for both sides that so far as their knowledge goes, this question has not been passed upon by any South Carolina court, but it does not seem to me that it could ever be said that a state has no law upon any given question merely because the precise question has not yet been passed on by any court. It seems to me to be the duty of the court in which the novel question arises to pass upon the question in the light of the pertinent statute law and analogous decisions, *if any, together with the decisions of other states and the court's own idea of reason and principle and public policy.*" (Italics ours.)

II.

THE OPINION OF THE MAJORITY OF THE CIRCUIT COURT OF APPEALS WAS IN ACCORDANCE WITH APPLICABLE STATE LAW.

A. Under Maryland Law, the Reservation of Dividends Under a Contract of Pledge Would Not Include a Stock Dividend.

(1) The rights of the First Mortgage Trustee are dependant upon the Principles of law applicable to pledges.

As Judge Parker observed, the answer to whether the First Mortgage Trustee or the Receivers is entitled to the stock dividend involves a consideration of the law applicable to pledges. These shares were declared as a dividend upon the 4,450 shares of R-W Company stock originally pledged with the First Mortgage Trustee. While the combination of a pledge and trust relationship may at first seem unusual, this situation is common in many deeds of trust where securities are lodged with a trustee to secure an issue of notes or bonds. Jones on Collateral Securities, 3rd Ed., Sec. 34, p. 42; Bogert on Trusts, Vol. 2, Sec. 246, p. 790. Upon analysis, it will be seen that the First Mortgage Trustee occupies a trust relationship with the bondholders. It holds in trust for their benefit the pledged securities, including the 4,450 shares of the stock of the R-W Company. As between Seaboard and the Trustee, a relationship of pledge exists with respect to the pledged securities. It cannot be supposed that the legal effect of a pledge is in any way different because it is made to a trustee.

(2) In the absence of an agreement to the contrary, the pledgee is entitled to all dividends and interest upon pledged securities.

The general rule established by a long line of decisions is that a pledgee of stock is entitled to all dividends paid thereon in the absence of any agreement to the contrary.

The authorities are fully collected in two annotations in American Law Reports, Vol. 67, p. 485 and in Vol. 103, p. 849. See also Railroad Credit Corp. v. Hawkins, 80 Fed. (2d) 818, and Corpus Juris, Vol. 14, Sec. 1243, p. 822 and Sec. 1116, p. 732. The application of this rule extends to *stock* as well as to cash dividends. Whetsel v. Forgey, 323 Mo. 681, 20 S. W. (2d) 523; Peoples-Pittsburg Trust Co. v. Saupp, 320 Pa. 138, 182 Atl. 376. The law of Maryland upon this point is in accord with the general rule and was settled by the case of Gemmell v. Davis, supra.

This Court is asked to decide whether the parties to the First Mortgage changed this rule by their agreement. The question is purely a contractual one between the Trustee on the one hand, as pledgee representing the bondholders, and Seaboard on the other. In view of the common law rights of a pledgee, it is reasonable to assume that Seaboard would have *expressly* reserved stock as well as cash dividends, if it was intended that the Railway Company should have both. Yet it failed to do so. The provisions touching closest upon this question are to be found in Section 1 of Article Three (R. 47) where it is provided that prior to certain events of default, none of which had happened at the time of the payment of the stock dividend in question, the Trustee

> "shall not collect or be entitled to collect the interest of any of the bonds or claims or indebtedness now or hereafter pledged with or assigned to the 'Trustee' under this indenture, and the 'Railway Company' shall be entitled to receive all interest paid or dividends declared in respect of any bonds or stocks transferred to or pledged with the Trustee pursuant to any of the provisions of this indenture."

Admittedly, this provision gave Seaboard, prior to the enumerated events of default, an undoubted right to all

cash dividends. It is submitted, however, that the use of the word "dividends" did not, and was not intended to, include stock dividends.

(3) The reservation of dividends by Seaboard under the First Mortgage did not include stock dividends.

While there is no decision precisely in point, the courts of Maryland, Virginia and North Carolina have passed upon the meaning of the word "dividends" as used in comparable relationships. In Virginia, in the case of Kaufman v. Charlottesville Woolen Mills, supra, the question was whether the purchaser of certain stock or the seller was entitled to a stock dividend declared shortly after the sale. It was a part of the agreement that the seller was to have dividends. Upon the subsequent declaration of a cash and a stock dividend, the seller claimed the right to both. In holding the buyer was entitled to the stock dividend, the court said at page 675:

> *"A stock dividend is not, in the ordinary sense, a dividend;* the latter being a distribution of profits to stock holders as income from their investment. A stock dividend is merely an increase in the number of shares, the increased number representing exactly the same property that was represented by the smaller number of shares." (Italics ours.)

Similar views as to the nature of a dividend have been taken by the courts in North Carolina. In the case of Lancaster Trust Co. v. Mason, 152 N. C. 660; 68 S. E. 235, a case similar to the Kaufman case, supra, the question was whether the seller of stock, reserving "January dividends" was entitled to stock as well as to cash dividends declared upon the stock. The court held the buyer was entitled to the stock dividends. These cases are entitled to particular consideration because they deal, not with testa-

mentary trusts but with the rights of the parties to a contract. Their reasoning is based upon the essential differences between a stock and a cash dividend.

In Maryland also the word "dividend" has been held to signify dividends payable only in cash. In the case of Smith v. Hooper, 95 Md. 16, 51 Atl. 844, where the court was required to pass upon the true meaning of a dividend as distinguished from the question of income, the Maryland Court of Appeals, at page 26, approved the reasoning of Gibbons v. Mahon, supra, and adopted the following definition of a "dividend" from the Connecticut decision of Spooner v. Phillips, 62 Conn. 62, 24 Atl. 524, saying:

> *"The word 'dividend', if unqualified"*, said the Supreme Court of Errors of Connecticut, *"signifies dividends payable in money.* The word 'income' has a broader meaning, but hardly broad enough to include things not separated in some way from the principal." (Italics ours.)

It is to be observed that the North Carolina court in the Lancaster case, supra, cited the Maryland case of Smith v. Hooper as authority for holding that the expression "January dividends" did not include a stock dividend. The Maryland Court of Appeals has never questioned the correctness of its decision in the Smith case; on the contrary, this decision has been cited with approval on many occasions. See the following cases:

The Atlantic Coast Line Dividend Cases, 102 Md. 73, 61 Atl. 295;

Ex Parte Humbird, 114 Md. 628, 80 Atl. 209;

Hagerstown Trust Company, 119 Md. 224, 86 Atl. 982;

Washington County Hospital Association v. Hagerstown Trust Company, 124 Md. 1, 91 Atl. 724;

Krug v. Mercantile Trust & Deposit Co., 133 Md. 110, 104 Atl. 414.

The view that a stock dividend is in reality not a dividend at all but strictly a capital adjustment has been repeatedly affirmed in a long line of Federal decisions, commencing with Gibbons v. Mahon, supra. See also Towne v. Eisner, 245 U. S. 418, and Eisner v. Macomber, 252 U. S. 189. Since the question at issue is the effect of a reservation of dividends under a contract, it cannot be improper to look for guidance to these cases, because they turn upon the precise meaning of the word "dividend". In this respect, as will be shown, they differ from the Maryland trust apportionment cases under which stock dividends are awarded to the life tenant or remainderman, as the case may be, depending upon the source of the funds out of which the dividend is paid.

(4) Consideration of the rules governing the allocation of stock dividends between life tenant and remainderman in the administration of trusts.

At the time of the declaration of the stock dividend on October 31, 1930, the Maryland Court of Appeals had adopted what is known as the Pennsylvania Rule in the disposition of stock dividends in the administration of trusts. The theory of that rule is that the trustee should examine the source of every dividend, and once having ascertained this fact, it should pay over to the life tenant so much of the dividend as represents earnings which have accrued to the company paying the dividend during the period of the tenancy. Opposed to this is the Massachusetts or Federal rule that all stock dividends, regardless of their source, should be treated as corpus upon the theory that they are a part of the original stock, and cash dividends should be treated as income.

It is submitted that the majority of the Circuit Court of Appeals was correct in refusing to apply to the present

case the Maryland trust rule of apportionment of stock dividends. There are fundamental and important distinctions between a trust and a pledge and these distinctions may be briefly listed as follows:

FIRST. The problem as to the disposition of a stock dividend in the case of trusts is fundamentally one of internal trust administration and the so-called Pennsylvania Rule, adopted in Maryland, represents an effort to make an equitable adjustment between the conflicting interests of life tenant and remainderman. "The problem", as one text writer has put it, "is what disposition must be made of the new and old stock after the stock dividend in order that justice may be done to the two parties interested under the trust, the immediate beneficiary and his successor." Bogert on Trusts, Vol. 4, Sec. 847, p. 2454.

In the case of a pledge, the situation is essentially one of the construction of a contract. As already seen, the moment a pledge is made, the pledgee becomes entitled to all dividends, both cash and stock, by virtue of the pledge itself. If the pledgor intends to reserve either cash or stock dividends, he must of necessity prepare the contract so that both are included. Merely to reserve dividends does not include stock dividends for, as previously shown, a stock dividend is in reality not a true dividend.

SECOND: The problem in the case of life tenant and remainderman is to make an equitable distribution of property which, if given to one or the other, is forever disposed of. If the stock dividend is paid over to corpus, it is lost forever to the life tenant except for future income thereon, and if treated as income, the remainderman suffers an even greater loss for he loses the

dividend itself and fails to receive any interest upon it. Naturally, the courts have striven to remedy this injustice even at the sacrifice of legal considerations as to the true nature of a stock dividend.

A pledge, however, is simply security for an indebtedness. If the stock dividend is given to the pledgee, as is the case at common law in the absence of any reservation, it would eventually revert to the pledgor when the principal debt is paid. Thus the pledgor suffers no ultimate loss. If the principal debt is not paid, the pledgor has no right to the stock dividend.

THIRD: A further distinction of importance is the fact of a debtor-creditor relationship in the case of a pledge. One of the parties advances money to the other and takes certain property as security therefor. Until the principal debt is paid, it is proper that all dividends upon the pledged securities should go to the pledgee. Certainly this is true where the pledgor has an opportunity, as in this case, to reserve them, and fails to do so. There is no hardship to the pledgor for the pledgee must account for all profits and increment. Story on Bailments, Secs. 339 and 343; Fletcher on Corporations, Vol. 12, Sec. 5645. And the pledgor may retain, as was done in this case, the right to vote the stock, receive the cash dividends thereon, and exercise all other rights of ownership with respect thereto.

In the case of trusts, however, a situation is presented where neither the life tenant nor beneficiary has advanced any money and both, as a rule, are the beneficiaries of a gift from a third person whose purpose is to secure for the one an income for his life and for the other the principal of the fund upon the

death of the first. As a rule, neither has a hand in the preparation of the trust instrument. Under such circumstances, all equitable considerations are in favor of distributing the stock or extraordinary dividends, as the case may be, as equitably as possible. The Maryland Court of Appeals has given repeated recognition to this principle. In the first of the cases cited by the Receivers, Thomas v. Gregg, 78 Md. 545, 28 Atl. 565, after having determined to apportion the stock dividend in accordance with the Pennsylvania Rule, the Court said at page 560:

"We think this plan an equitable one."

And again at page 556:

"When it is possible for the court to ascertain whether the distribution in the stock dividends includes net earnings, and, if so, what proportion, and also whether such earnings were intended to be made a part of the capital or merely to be used temporarily with the intention on the part of the directors of refunding them to the shareholders as income, we think it is the duty of the court to make such investigations and dispose of the stock *in an equitable* way between the tenants for life and the remaindermen."

And in one of the latest Maryland cases upon this subject, Baldwin v. Baldwin, 159 Md. 175, 150 Atl. 282, the court reiterated the point expressed in the Gregg case to the effect that the controlling factor was an equitable adjustment of the conflicting interests between life tenant and remainderman. At page 181 of that report, the court said:

"The Pennsylvania Rule was adopted by this Court without qualification. It was chosen in preference to other rules which, while susceptible of more convenient application in the disposition of extraordinary dividends, were also capable of *causing injustice to the remainderman or to the life tenants.*"

In applying the Pennsylvania Rule, the Maryland court has never rested its decision upon the meaning of the word "dividend". In fact this is the differentiating factor between the Pennsylvania and the so-called Massachusetts Rule. In Maryland, the determining factor is the source of the funds out of which the dividend is paid. The Maryland court has frequently awarded a stock dividend to the remainderman despite the direction of the testator that all dividends should go to the life tenant.

FOURTH: A pledge involves more than the mere deposit of certain shares of stock; it may involve, as it did in the present case, the pledge of a very definite stock ownership interest in a corporation. The R-W Company stock has at all times been owned equally by six railway companies and when the 4,450 shares were pledged under the First Mortgage in 1901, the Trustee acquired by the pledge a one-sixth interest in that Company. To permit Seaboard to retain the stock dividend in question depreciates the value of the pledge because it automatically reduces the interest of the First Mortgage Trustee from a one-sixth interest to approximately a one-ninth interest. Even the loss of one share would be important in this case, as it would cause the Trustee to lose its position of parity with the five other competitive roads.

FIFTH: That it is improper to apply the trust rule in the case of a pledge can be demonstrated if we suppose a situation where the stock dividend is paid out of funds which have accumulated prior to the creation of the pledge. The Maryland trust apportionment rule would require an allocation of the stock dividend between the pledgor and pledgee. But this cannot be reconciled with a contract wherein it is stipulated that

> the pledgor shall have all dividends. It results in an unwarranted effort on the part of the court to remake and revise the contract. Clearly, either the stock dividend goes in its entirety to the pledgee under the common law or it goes in its entirety to the pledgor by virtue of the expressed reservation. There is no possible way to justify an in-between ground.

The Special Master fully appreciated this problem and his words were quoted with approval by the majority of the Circuit Court of Appeals. He said (R. 152):

> "But because a court would not adopt such a rule as this in order to protect a life tenant, it does not follow that it 'regarded a stock dividend as a real dividend' * * * especially when, as in the case of the Maryland court, it had expressly said that such a dividend was not a real dividend. And, because a court might think it would be just to give such a dividend to the life tenant rather than to the remainderman, in order to prevent the former from being prejudiced by the refusal of a corporation to declare cash dividends, it does not follow that it would consider it just to give it to a pledgor as against a pledgee, if, by so doing, it would *impair the principal of the pledgee's securities.*"

B. The Lien of the Receivers' Certificates Did Not Attach to Either the Stock or Cash Dividends.

In considering this question, it is worthwhile to observe that no question of local law is involved. As will be seen by a reference to the brief filed by the Receivers in support of their petition for certiorari, every case cited by them upon this subject is either a Federal or Supreme Court decision. The reason is plain. The basis of the controversy is simply the scope and effect of certain orders passed by the District Court upon their applications Nos. 19, 63 and 160 for the issuance of Receivers' Certificates (R. 87. See also R. 174 and 122.)

By their terms, these orders purported to create a first lien in favor of the holders of Receivers' Certificates upon the property of Seaboard "in the possession of or under the control of the Receivers" (R. 125). The Receivers now contend that because the stock dividend shares and the cash dividends were in their possession at the time these orders were passed, they became impressed with a lien irrespective of the fact that their possession may have been wrongful.

At the outset, it is essential to bear in mind that no contention has ever been made by the Receivers that the lien of the Receivers' Certificates extends to the pledged securities in the possession of any of the Mortgage Trustees. The Receivers, for example, have at all times conceded that the original 4,450 shares of R-W Company stock pledged with the First Mortgage Trustee are free of lien. It could not be contended otherwise, because the jurisdiction of the Receivers has never extended to securities in pledge under the various Mortgages. In the order appointing Receivers for the properties of Seaboard subject to the First Mortgage, entered by the District Court on May 29, 1931, it was expressly provided that the Receivers should,

> "be and they are hereby appointed * * * Receivers of all and singular the railroad, rolling stock, equipment, franchises, rights, interests, property and premises of every kind and description and wheresoever located belonging to the defendant, Seaboard Air Line Railway Company, and covered by and embraced in or under said First Mortgage (*other than the securities, and other property pledged to and now in the possession of the Complainant, The Continental Trust Company*) situate within the jurisdiction of this court, and of the totals, earnings, income, rents, issues and profits of the same and every part thereof, * * *". (Italics ours.)

An analysis of Receivers' application No. 19 (the same general pattern was followed in applications No. 63 and 160) reveals that no mention was made either in the petition itself or in the attached exhibits (R. 106 and 109) as to the fact that the 2,225 stock dividend shares were in the possession of the Receivers and were to be subject to the lien of the certificates. At the hearing upon this application, Exhibit 7 was introduced (R. 164) purporting to show a list of the free assets of Seaboard, and among the securities listed was the R-W Company stock dividend; but, as the Special Master has aptly pointed out in his very able and exhaustive discussion of this whole question, this exhibit was prepared from the Receivers' records and there was no finding by the court that it was correct. The only issues presented by the application were:

> FIRST, the necessity for the issuance of the Certificates, and
>
> SECOND, whether or not the security for the Certificates was to be all of Seaboard's assets, whatever those assets might be.

The Special Master's conclusion in this respect carries particularly weight because it was he who was appointed by the District Court to pass upon the issues of law and fact presented by the Receivers' original application to issue Certificates. Quoting from his opinion (R. 167):

> "The application did not contemplate that any question of title or of an existing lien, as between the Receivers, the First Mortgage Trustee, the Refunding Mortgage Trustees, or any other claimant, was to be passed upon. All that was contemplated was that the Court should decide that the issue of the certificates was necessary, and that they should be secured by all of the assets of the railway company, whatever these assets might be, and, to repeat, these were the only

> questions considered at the hearing before the Special Master, or after it by the court. It is apparent that neither the Special Master nor the court for a moment thought that they were deciding any issue as to title, or lien, or priority of claim. They were only deciding that the amount which the Receivers stated that they needed was in fact needed, and that, in order to borrow this amount, it was necessary that all the assets of the railway company should be pledged. But there was no issue raised, nor any decision made, as to whether any particular asset was in fact a free asset of the railway company."

The authorities fully sustain the Master's position.

> Cromwall v. County of Sac., 94 U. S. 351;
> New Orleans v. Citizens' Bank, 167 U. S. 371, 406;
> Baltimore S. S. Co. v. Phillips, 274 U. S. 316, 319;
> Radford v. Myers, 231 U. S. 725, 733;
> Oklahoma v. Texas, 272 U. S. 21, 41.

Furthermore, it is to be noted that the order entered by the District Court upon application No. 19 by its terms purports to subject only the property "of the Railway Company" to the lien of the Receivers' certificates (R. 125). For reasons which have been discussed, neither the stock nor the cash dividends can properly be regarded as the property of Seaboard so as to come within the scope of the language of the order. Seaboard was not simply under an obligation to turn over to the First Mortgage Trustee an amount of property equivalent to the stock and cash dividends in dispute. On the contrary, it is submitted that this specific property belonged to the Trustee. The cases clearly hold that where the pledgor receives the increment of pledge which is under a duty to turn over to a pledge, such increment is held by the pledgor in constructive trust. It cannot be considered as the property of the

pledgor. In the case of Peoples-Pittsburg Trust Co. v. Saupp, 320 Pa. 138, 182 Atl. 376, the court clearly held that the retention by the pledgor of a stock dividend upon pledged securities gave rise to an implied or constructive trust. See also Jones on Collateral Securities, 3rd Ed., Sec. 398.

CONCLUSION.

In conclusion, it is respectfully submitted that neither of the questions raised by the Receivers should be reviewed by this Court. Particularly is this true of the question pertaining to the lien of the Receivers' Certificates. If a review is granted, it should be limited to the first question which deals with the effect of the reservation of dividends under the First Mortgage.

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